The KDM Dairy Report - December 8th, 2006

Bullish Fundamentals:

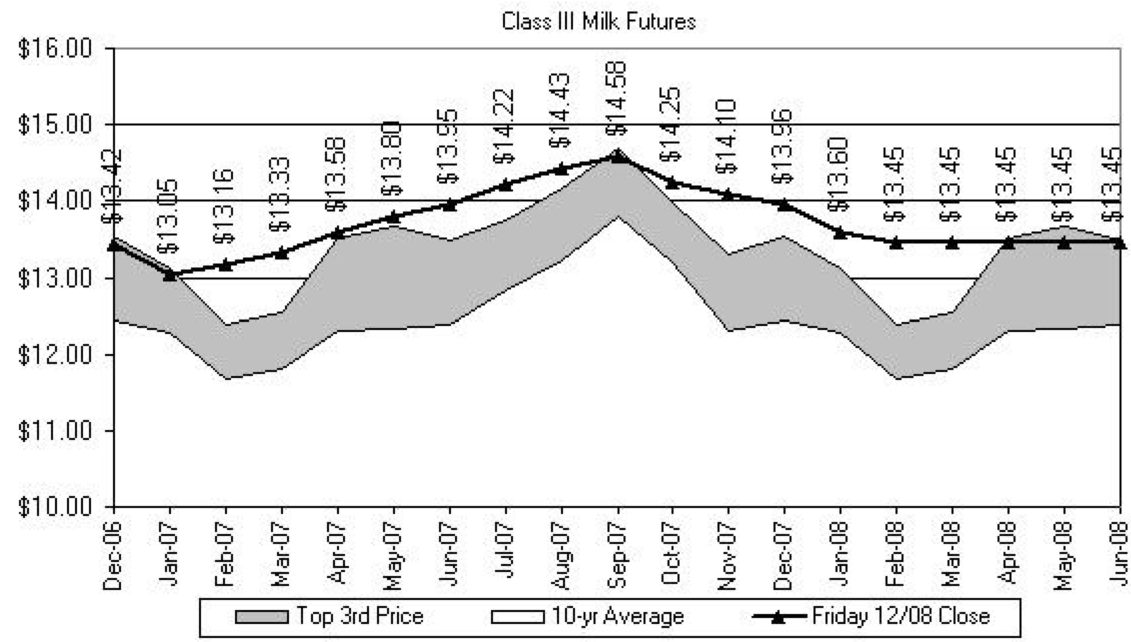
Futures Month	Friday 12/08 Close	Friday 12/01 Close	Change	10-yr Average	Top 3rd Price
Dec-06	$13.42	$13.35	$0.07	$12.44	$13.53
Jan-07	$13.05	$13.03	$0.02	$12.27	$13.11
Feb-07	$13.16	$13.10	$0.06	$11.68	$12.37
Mar-07	$13.33	$13.13	$0.20	$11.82	$12.54
Apr-07	$13.58	$13.38	$0.20	$12.30	$13.51
May-07	$13.80	$13.51	$0.29	$12.32	$13.67
Jun-07	$13.95	$13.67	$0.28	$12.39	$13.49
Jul-07	$14.22	$14.03	$0.19	$12.82	$13.74
Aug-07	$14.43	$14.33	$0.10	$13.23	$14.17
Sep-07	$14.58	$14.38	$0.20	$13.79	$14.68
Oct-07	$14.25	$14.07	$0.18	$13.19	$13.98
Nov-07	$14.10	$13.92	$0.18	$12.32	$13.30
Dec-07	$13.96	$13.86	$0.10	$12.44	$13.53
Jan-08	$13.60	$13.50	$0.10	$12.27	$13.11
Feb-08	$13.45	$13.45	$0.00	$11.68	$12.37
Mar-08	$13.45	$13.45	$0.00	$11.82	$12.54
Apr-08	$13.45	$13.45	$0.00	$12.30	$13.51
May-08	$13.45	$13.45	$0.00	$12.32	$13.67
Jun-08	$13.45	$13.45	$0.00	$12.39	$13.49
2007 Avg	**$13.87**	**$13.70**	**$0.17**		
Jan-Jun '08	**$13.48**	**$13.46**	**$0.02**		

- NASS surveyed prices were up for most Class III components, rebounding from last week. 40-lb blocks were up 2.7¢ from last week, averaging $1.37/lb, while 500-lb barrels increased 2.2¢ to $1.42/lb. Nonfat dry milk was up 1.9¢ to finally breach $1/lb on the NASS survey, reaching $1.02/lb. Dry whey bounced back from last week's drop to increase a strong 2.6¢, bringing it to 40.1¢/lb. Finally, butter was the lone weak component, losing 0.6¢ to average $1.26/lb.
- Milk production is increasing moderately in the East, but demand for Class I, II and III is still strong, according to Fluid Milk & Cream Review; 14 more loads were imported into the region this week vs. last week. Milk is still tight and balancing plants are handling lower than average milk volumes. Strong fluid demand is continues to attract more milk, decreasing weekly churning and drying.
- Milk prices have not been increasing enough to offset the higher prices for feed, replacement animals and fuel, according to Fluid Milk & Cream Review. Producer concern in these areas is growing. The same situation is noted for producers in the Pacific Northwest, who were not able to do much profitable contracting for feed supplies. Higher feed bills and marginal hay quality are adding financial stress.
- The dry whey market remains very tight, according to Dairy Market News. The price is expected to stay near unchanged for the remainder of the year and demand is good from both domestic and export markets.
- International: Exporters looking for dairy end products are hard pressed to find them in Europe, according to Dairy Market News. Milk production is near the annual low and powder prices are at record high levels, causing "sticker shock" amongst prospective buyers. Some exporters expect to be out of the international market until spring, hoping for a rebound in milk production.
- International: Milk production in New Zealand is about the same as last year, but down nearly 7% in Australia due to the El Nino- induced drought. The cost of feed and water is a financial strain, and has led to additional culling. Exporters are expressing concern about meeting current commitments.
- October fluid milk sales were up a solid 1.5% vs. October 2005, according to Dairy Market News. Sales continue to be led by increases in low-fat flavored milk. YTD, fluid sales are up 1.0%

Bearish Fundamentals:

- Cash market: Blocks were unchanged on the week, holding at $1.32/lb, but barrels lost another 2¢, closing at $1.28/lb today. Butter continued to lose ground, shedding 2¾¢ to close at $1.25/lb. 9 loads of blocks, 5 barrels and 35 cars of butter exchanged hands.
- Cream offerings were heavier than expected in the Midwest this week, according to Fluid Milk & Cream Review. In addition, handlers note that milk receipts appear to have turned the corner and are on the increase.
- Nonfat dry milk is still tight in the Midwest; however, Dairy Market News reports buyers are starting to hold back on purchases in expectation of lower prices and increased supply in the near future.
- The market tone for butter is weaker, according to Dairy Market News. Retail and food service sales have been good, but production and stocks are easily able to service needs.
- Dairy Market News reports cheese supplies in the Midwest are loosening up a bit. A few extra loads of barrels were reported this week, as well as natural American supplies. Cheese output is increasing on great yields and increasing milk production.

Recommendation:



We're hearing several mentions of financial stress on dairies due to higher feed prices relative to the milk price. With December setting up as a good bump in the milk check, it may help the financial situation. However, if go back down to the mid $12 level for Class III during the first quarter, it may be enough to start the liquidation process beginning in the West. We'll be watching the key indicators: cow numbers, production per cow, and cattle prices. Corn prices moving above $4/bu could quicken the pace, and with hay quality questionable and prices firm, financial stress is increasing. This should lead to a solid price recovery for Class III milk in the 2nd half of 2007 and into early 2008.

The cheese market looks to be loosening up in the near term with no major shortage of cheese. Holders of product favor a lower price to reduce inventory into the end of the year, but after that will be assessing needed levels and replenishing for new aging programs. This could cause the price for cheese to move higher at the CME early next year.

If you are a producer still needing to get covered on your feed needs, you should look at contracting both your corn and soybean meal needs now on the recent correction in the market. Strong forecasted demand makes the potential for higher prices greater than lower.

First quarter remains vulnerable. We would continue to recommend getting coverage here if it is a profitable price for you, but then purchase CALL options to protect your sale from a price recovery after the New Year. Our long-term view remains supportive. Sell only up to 25% of your production at profitable prices.